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SUBJECT: RUSSIAN ECONOMIC PROGRESSIVES VS. CONSERVATIVES:  
ROUND ONE, BUDGET/BANKING POLICY RIFT

Classified By: ECMIN Eric T. Schultz, Reasons 1.4 (b/d).

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Summary  
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1. (C) The GOR's resolution of April 1 to authorize deposits of so-called "temporarily available budget funds" into commercial bank accounts is not being uniformly welcomed by policy makers. During an April 2 conference hosted by the Association of Russian Banks (ARB), representatives of Russia's progressive and conservative economic policy factions expressed disagreement about the resolution's benefits for the banking sector. Chief of the Presidential Administration's Experts Directorate Arkadiy Dvorkovich outlined the Ministry of Economic Development and Trade (MEDT) viewpoint that inflation concerns should not dominate policy considerations and that putting budget resources into the banking sector would stimulate growth. Central Bank (CBR) Chairman Sergei Ignatyev's rebuttal emphasized that inflation remained a significant concern and that, in the economy's current state, credit quality was more important than credit growth. We will examine a similar dispute over tax policy septel. End Summary.

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Background on Liquidity Proposal  
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2. (U) Last fall, the GOR proposed transferring "temporarily available" budget funds (i.e., funds allocated but not yet disbursed) to commercial bank accounts as a means of increasing liquidity. The proposal emerged at the same time as the subprime crisis-induced credit squeeze was beginning to affect Russian commercial banks' ability to procure short-term credit financing. In the meantime, the Central Bank (CBR) acted to maintain confidence in the banking sector by easing banks' access to the CBR's short-term credit. Reserve requirements were reduced and the list of collateral that could be used for refinancing (repo) transactions was expanded.

3. (U) Despite these changes, the CBR's short-term credit remained beyond the reach of many of the country's smaller banks. The "temporarily available" funds proposal came to be seen as a way supporting an even wider array of banks. On April 1, the GOR issued a resolution allowing the placement of funds in bank accounts, pending the publication of technical regulations by the Finance Ministry in conjunction

with the Ministry of Economic Development and Trade (MEDT) and the Central Bank by as early as mid-April.

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Budget Resources in Banks: For  
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¶4. (U) Experts Directorate Chief Arkadiy Dvorkovich used his presentation at the 19th Congress of the Association of Russian Banks (ARB) on April 2 to emphasize his support of the April 1 resolution. "With all due respect to the Central Bank's professional analysis, the Russian economy (is) not overheating," according to Dvorkovich. In 2007, he said, the government "finally realized that credit growth had significantly contributed to economic growth." He added that Businesses and retail borrowers as well as long-term corporate investments and long-term infrastructure projects would benefit if the banking sector could use state resources to expand available lending. Using temporarily available budget resources was a critical first step in spurring the development of long-term deposits which banks could transform into long-term financing.

¶5. (U) Dvorkovich's comments were echoed and supported by other presenters at the ARB event. Moscow Deputy Mayor Yuriy Roslyak lamented that Stabilization Fund assets were being invested in debt instruments and banking accounts in Europe and the U.S., providing long-term financing to those markets at high interest rates. He supported the budget funds resolution and called on the country's senior officials to "defend" Russia's monetary resources by supporting the national banking system. Deputy Prime Minister Aleksandr Zhukov also supported increased access to public resources as a means of generating longer-term funding for banks so that commercial banks could become "a locomotive of development."

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Budget Resources in Banks: Against  
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¶6. (U) Later in the conference, CBR Chairman Sergei Ignatiyev rebutted Dvorkovich, noting that current global economic conditions meant that banks should be "more cautious about their credit growth." For instance, he said, despite the slower retail credit growth among Russian banks in 2007 compared to 2006, the volume of non-performing loans had increased. He also did "not exclude the emergence of a financial bubble" in the residential construction market during the next two years. Addressing the budget funds resolution obliquely, Ignatiyev said that banks would be better served by focusing on risk management since "a higher volume of loans issued would not necessarily mean higher quality loans."

¶7. (U) Chairman of the Board of MDM Bank Oleg Vyugin supported Ignatiyev's position, characterizing the budget resources resolution as a political decision. He said banks would not be able to count on receiving budget funds since any number of emergencies, shocks, or changes in budget policy would take precedence over a given bank's liquidity needs. The resolution, moreover, did not require banks to use collateral to acquire the funds, which, according to Vyugin, put the deposited budget resources at risk, regardless of a given bank's international rating.

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Comment  
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¶8. (C) The apparent split within the government's economic liberals over policy also played out publicly last week when Deputy Prime Minister Kudrin and Economic and Trade Minister Naibullina disagreed at another conference over tax policy (septel). In our view open debate over economic policy in Russia is a very positive development. Instead of arguing over who gets what asset, the GOR is having a very western style discussion about how to best grow the economy under President-elect Medvedev.

